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May 28, 1997

Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
P.O. Box 25165
MS 3101
Denver, CO. 80225

Re: Comments for Proposed Rules for Oil Royalties

Dear Sir or Madam:

Wyoming Refining Company (WRC) submits these comments on the Minerals Management Service's (MMS) proposed rules concerning the determination of royalty value for oil produced from federal oil and gas leases, 62 Fed. Reg. 3742 (January 24, 1997).

BACKGROUND AND SUMMARY OF WRC'S POSITION

WRC is the owner of a single refinery in Newcastle, Wyoming. The refinery primarily supplies markets in the northeast corner of Wyoming and the Black Hills of South Dakota, including Ellsworth Air Force Base. Being a small independent refiner, WRC has long qualified for the federal government's royalty-in-kind (RIK) program which has helped the company meet its need for a dependable crude oil supply.

WRC has much at stake in the outcome of the MMS' proposed rules affecting 30 CFR parts 206 and 208. In particular, WRC is sensitive to the provisions of the new rule correcting MMS' current position that undervaluations of RIK oil should be covered by the refiner rather than the producer. In fact, WRC is presently involved in litigation with the MMS over this very issue. Future problems over RIK valuations can be avoided if certain goals are achieved in the new rule. Of course, the ultimate goal is for small refiners like WRC to be afforded access to long term crude oil supplies.

Some of the goals that WRC would like to see in the new rule include:

1. Allowing purchasers of RIK oil to "opt in" and "opt out" of contracts without terminating the contract. Although WRC would prefer the ability to opt in or out on a month-to-month basis depending on the price of the RIK oil being offered, even the ability to do so quarterly without cancellation once a single shipment of RIK oil is rejected will improve on the present situation.

2. Getting rid of the threat of retroactive pricing due to post-sale audits by having a definite oil price and by having the purchaser of the RIK oil forever meet its financial obligations to the federal government when the invoice for delivery of the oil has been paid.

3. Place the ultimate responsibility for any errors in reporting the value of RIK oil to MMS on the producer of that oil rather than on the purchaser of that barrel.

4. Have the MMS allow any true arm's length sales of crude oil to be taken into account when setting the price of RIK oil for refiners. In fact, WRC suggests that MMS take the ultimate arm's length approach to valuing crude oil by negotiating the valuation provisions of each RIK sales contract with the particular purchaser rather than unilaterally dictating an external standard. Whatever the parties agree to accept, be it posted prices, NYMEX indices or some other standard, will set the price for the term of the contract until otherwise amended. Perhaps an escape clause can allow either party to request a modification in the pricing calculus if the current standard no longer reflects the oil's value. Agreement on a new valuation standard must be reached within a specified time limit or further RIK deliveries will be canceled for the remainder of the contract. WRC asks: what could be more arm's length than the owner of the oil and the purchaser agreeing on what the price will be? Each party will be accepting the risks and receiving the benefits of its bargain.

Should the above goals be met in the language of the proposed rule, then WRC will support its adoption. Of key interest will be the provisions whereby the value of the oil is established. As a practical matter, the producer must be at risk for its incorrect valuation in order to be a reliable source of oil prices. WRC is not only interested in making sure that the value of the RIK oil is fairly established but also in who will be accountable for its accuracy.

COMMENTS ON MMS' PROPOSED RULE CHANGES TO 30 C.F.R. PART 208

A. MMS' statement that the current provisions of 30 C.F.R. 208 are "onerous to the producers and creates risk for the small refiners."

Comments:

WRC agrees with MMS' statement. Under MMS' untested interpretation of the current rules governing the RIK program at 30 C.F.R. 208, and the corresponding valuation provisions of 30 C.F.R. 206, small refiners are subject to substantial risk from the threat of indefinite, retroactive price increases based on future audits by MMS. Under such circumstances, the small refiner can have no confidence in the price billed by MMS and paid by the refiner under the terms of the RIK contract. MMS' currently asserted right to retroactive price adjustments based on future audits deprives small refiners of any form of predictability or stability in contracting for royalty oil. Furthermore, this approach puts small refiners at substantial financial risk when MMS redetermines a new price for RIK oil years after the oil has been paid for and exchanged by the RIK purchaser on the basis of the originally invoiced price. Under the present system each and every purchase of RIK oil creates a contingent liability on the books of the small refiner. Finally, subjecting small refiners to this type of financial uncertainty thwarts the purposes of the Mineral Leasing Act's Small Refinery Program which was intended to preserve the ability of small refiners to compete against vertically integrated oil companies.

B. The Royalty Policy Committee's (RPC) three possible improvement options for the RIK oil program.

1. "Eliminate reporting on the Form MMS-2014."

Comments:

If MMS intends to eliminate Form MMS-2014, and to use the NYMEX-based index pricing method, then whatever reporting instrument MMS selects should clearly indicate what volumes the producer has delivered to the RIK purchaser. The RIK purchaser should receive a copy of this form at the same time the producer reports this information to the MMS. In this respect, the RIK purchaser can make appropriate financial decisions regarding its continued participation in the RIK program.

2. "Establish product value in the RIK contract."

Comments:

This approach could provide the RIK purchaser with some additional certainty in contracting with MMS. However, the RIK contract must retain mechanisms which allow the RIK purchaser to make sound financial decisions. For example, the contract should retain the right to suspend future deliveries for a particular time period if the price is unilaterally determined by MMS and is too expensive for the RIK purchaser during that particular time period. This ability to "opt out" of the RIK contract on a periodic basis and to "opt in" again once the price of oil becomes competitive with other supply options should be at the heart of any progressive changes made in the wording of the RIK contract. Furthermore, it is important to know whether the contract would state one particular market center for the purpose of calculating the location or quality differential or whether the RIK purchaser could identify alternative locations in the contract, so that oil could be purchased at different locations depending on the company's changing needs. Again, WRC suggests that arm's length negotiation of these details between the parties to each contract may be more accurate and efficient than attempting to establish by rule a universal one-size-fits-all formula for all contracts.

3. "Bill entitled volumes from the Form MMS-3160, Monthly Report of Operations."

Comments:

Any form MMS selects must provide the RIK purchaser with certainty in the billing process.

C. RPC's concerns over the current administrative burden of "reconciling what volumes the small refiner actually took, what value to assign the small refiner volumes, who is to pay for what volumes, and who owes for what volumes."

Comments:

WRC believes that the RPC's concerns reflect the uncertainty inherent in the current rules regarding which party is responsible when errors occur in reporting volumes and values for RIK oil. This uncertainty has been fostered by MMS' inconsistent interpretation of the existing rules. Any changes in valuation and reporting adopted by MMS must clearly establish that, while the RIK purchaser is responsible for paying for all volumes actually received, the unit price in the RIK contract invoices will not be subject to further adjustment. Producers will have no incentive to accurately report the information that determines the value of RIK oil if they believe the burden of their errors will be borne by the small refiner RIK purchaser. If the producer's reported value is to serve as the RIK contract value, penalties for late or incorrect reporting need to be established and implemented with increasingly severe penalties reserved for those producers who consistently make errors. If producers are not made liable for their reporting errors affecting valuation, the RIK purchaser will face the same kind of financial risk and uncertainty that exist under the current rules. Again, the negotiated acceptance of a pricing standard in the RIK contract by both the MMS and the purchaser can eliminate this issue.

D. Revisions to 208.4(b)(2) requiring MMS to calculate and provide the value determined under 30 C.F.R. 206.102(c)(2) to the RIK buyer.

Comments:

Requiring MMS to provide the value determined under 30 C.F.R. 206.102(c)(2) to the RIK purchaser could help remove the uncertainty and financial risk which exists under the current rules. However, if errors in pricing are determined at a later date through audit, then the producer must assume responsibility for those errors. It is imperative that the new rule clearly state that there will be no retroactive price adjustments made against a RIK purchaser for errors of value, as opposed to errors of volume, once an MMS invoice has been delivered to and paid by a refiner. Accordingly, the language in the proposed rule should be amended to read: "MMS will calculate and provide that value to the buyer in an invoice and, while the invoiced amount will be subject to later adjustment based on an error in volume, the invoiced amount will not be subject to later adjustment for an error in value." If MMS determines that the valuation standards for the oil can be negotiated between the parties and set out in each contract, the preceding suggested language should start with the phrase, "Using the standards adopted by MMS and the purchaser in the RIK contract, MMS will calculate and provide that value . . . ."

COMMENTS ON MMS' PROPOSED RULE CHANGES TO 30 C.F.R. PART 206

If MMS determines that arm's length negotiations between the owner/seller and the purchaser of the oil are the best and most efficient means of valuing RIK oil, then RIK valuations could be exempted from the proposed Part 206 NYMEX-based index pricing altogether. Valuations imputed to oil where the producer pays the royalty in value will become irrelevant to an RIK situation where two parties have accepted the risks and benefits of an arm's length sale. If, however the proposed Part 206 rule changes are applicable to RIK sales, WRC has the following comments.

The proposed rule providing a formula-based price effectively would have the small refiner paying at least a "spot market" price, despite the fact that the refiner's purchase contract is long term. MMS is thereby asking to receive the highest price available at all times through the life of this long term contract. Such a demand is unheard of in the industry. Furthermore, it does not take into account the fact that the small refiner has additional costs of participating in the small refiner RIK program, including the costs of administration, surety, and letter of credit. In fact, there is little doubt that if WRC were to continue its participation in the RIK program under the proposed rules, the barrels purchased would be the most expensive supply barrels in WRC's supply program by a wide margin. Therefore, WRC would likely be a non-participant in the small refiner RIK program.

NYMEX and Platt's averages (as well as other indices) are generally indicative of the incremental supply barrel of refiners. Most transactions on the spot market are made for the purpose of securing "incremental" supply. These incremental barrels are purchased by refiners in the spot market when refinery margins suggest higher run levels. Because of this fact, the spot market tends to value crude oil higher than the average refinery supply purchase. Thus, logically this means the new formulaic pricing will generally result in only the highest priced crude of large refiners offered to the small refiner.

NYMEX-based sales are not without associated costs that must be taken into account in translating the NYMEX price into a value at the lease. The desire of the MMS to market all of their royalty barrels as though they were already at Cushing lacks the real world costs of moving those barrels (either physically or by trade) in several ways. For a producer to market barrels at Cushing, many costs are absorbed. First is the cost of a marketing staff to handle the details. Second there are the administrative and miscellaneous costs of dealing with transactions including the costs of NYMEX trading. These include NYMEX transaction fees, margin money, and credit costs of physical exchanges. Trading is based on round volumes both at NYMEX and with Platt's. No consideration within the MMS proposal is given to the fact that the MMS volumes are not round lots, and there are applicable market discounts, and inventory costs that result from not owning round lots. In addition, there are physical costs that are not included. Among these are line fill costs that occur when one is a shipper in many pipeline systems. There are also transfer costs and pipeline loss allowance costs that have not been given consideration.

The MMS proposal allows only pipeline costs that are self determined. When selling the RIK barrel to a small refiner, the refiner will still have to pay the pipeline company the FERC established tariffs. The cost of purchasing the barrel could therefore be prohibitive, in this manner alone, to the small refiner.

The annual updating of the differentials from market centers and aggregation points is disturbing. An important concern in this regard would be the accuracy of the reporting. If a report was incorrect, and contract volumes changed or were canceled, there could be discrepancies that may linger, or never be corrected.

The MMS proposal for Nymex-based pricing has a timing problem. The proposed format is not in agreement with standard industry trading practice. A more appropriate method would be to take the prompt month average from the first day to the last day of the production month, i.e., for September 1996 production, the average would be based on the October contract close from September 1 through September 22, and the November contract from September 23 through September 30.

Another concern is the possible manipulation of the NYMEX and trading indices. The NYMEX settlement is based only upon the last five minutes of trading each day. Large market players could possibly trade contrary to their normal interests for the purpose of influencing the settlement. The same could be true of index trading. Moreover, the players may have little or no business in energy, but rather just energy markets.

It is crucial that the small refiner pay only for volumes actually delivered, rather than the MMS' allocated portion of the production. In this regard, the producer should have some incentive both to actually deliver the appropriate volume and report that volume correctly. Perhaps sufficient penalties imposed by the MMS for lack of performance in either case would give assurance to the small refiner of cooperation by the producer.

Sincerely,

Thomas L. Sansonetti, P.C.
Karol Kahalley
for Holland & Hart

cc: Bob Neufeld, Wyoming Refining Company